

Monetary Stability

Despite a volatile external environment, the Hong Kong dollar exchange rate traded within a very narrow range against the US dollar throughout 2012. The Linked Exchange Rate system (LERS) remained a cornerstone of Hong Kong's monetary and financial stability, and the money market continued to function smoothly with ample interbank liquidity.

OBJECTIVES

The overriding objective of Hong Kong's monetary policy is currency stability. This is defined as a stable external exchange value of Hong Kong's currency, in terms of its exchange rate in the foreign exchange market against the US dollar, within a band of HK\$7.75 – 7.85 to US\$1. The structure of the monetary system is characterised by Currency Board arrangements, requiring the Monetary Base to be at least 100% backed by US dollar reserves held in the Exchange Fund, and changes in the Monetary Base to be 100% matched by corresponding changes in US dollar reserves.

The Monetary Base (Table 1) comprises:

- Certificates of Indebtedness, which provide full backing to the banknotes issued by the three note-issuing banks
- Government-issued notes and coins in circulation
- the Aggregate Balance, which is the sum of clearing account balances of banks kept with the HKMA
- Exchange Fund Bills and Notes issued by the HKMA on behalf of the Government.

The stability of the Hong Kong dollar exchange rate is maintained through an automatic interest rate adjustment mechanism and the firm commitment by the HKMA to honour the Convertibility Undertakings (CUs). When the demand for Hong Kong dollars is greater than the supply and the market exchange rate strengthens to the strong-side CU of HK\$7.75 to the US dollar, the HKMA stands ready to sell Hong Kong dollars to banks for US dollars. The Aggregate Balance will then expand to push down Hong Kong dollar interest rates, creating monetary conditions that move the Hong Kong dollar away from the strong-side limit to within the Convertibility Zone of 7.75 to 7.85. Conversely, if the supply of Hong Kong dollars is greater than demand and the market exchange rate weakens to the weak-side CU of HK\$7.85 to the US dollar, the HKMA will buy Hong Kong dollars from banks. The Aggregate Balance will then contract to drive Hong Kong dollar interest rates up, pushing the Hong Kong dollar away from the weak-side limit to stay within the Convertibility Zone.

Table 1 **Monetary Base**

\$ million	31 December 2012	31 December 2011
Certificates of Indebtedness ¹	291,675	259,815
Government-issued currency notes and coins in circulation ¹	9,997	9,930
Balance of the banking system	255,851	148,684
Exchange Fund Bills and Notes (EFBN) issued ²	661,396	658,748
Total	1,218,919	1,077,177

¹ The Certificates of Indebtedness and the government-issued notes and coins in circulation shown here are stated at Hong Kong dollar face values. The corresponding items shown in the balance sheet of the Exchange Fund in this Annual Report are in Hong Kong dollars equivalent to the US dollar amounts required for their redemption at the prevailing exchange rates on the balance sheet date. This arrangement is in accordance with the accounting principles generally accepted in Hong Kong.

² The amount of EFBN shown here is different from that in the balance sheet of the Exchange Fund in this Annual Report. In accordance with the accounting principles generally accepted in Hong Kong, the EFBN held by the HKMA on behalf of the Exchange Fund in relation to its trading of the EFBN in the secondary market are offset against the EFBN issued, and the net amount is recorded in the balance sheet. The EFBN issued on tender dates but not yet settled are included in the balance sheet but excluded from the Monetary Base.

Monetary Stability

REVIEW OF 2012

Exchange-rate stability

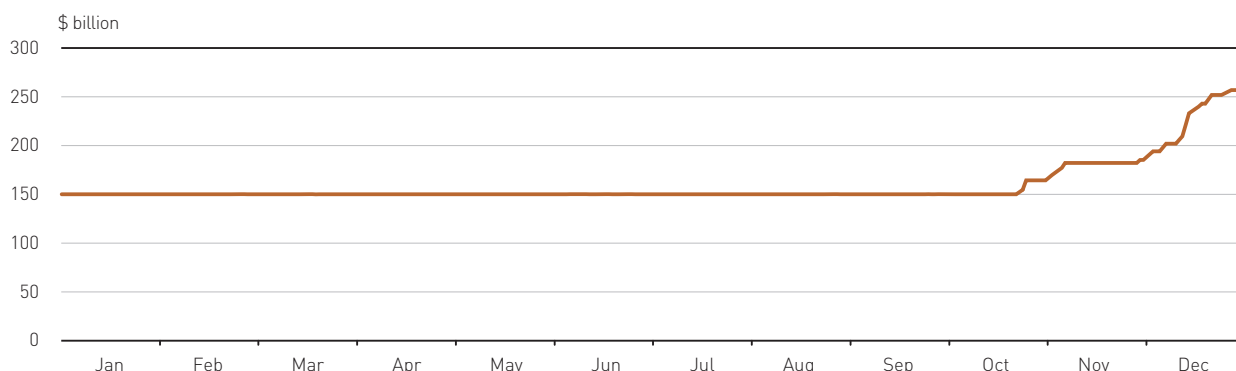
The Hong Kong dollar exchange rate remained within a very narrow range against the US dollar (Chart 1). In the first half of the year, the Hong Kong dollar exchange rate strengthened gradually from around 7.770 to 7.755 against the US dollar, although with occasional fluctuations amid the uncertainties surrounding the global economic and financial environment, particularly the ongoing European sovereign debt problems. In July and August, the Hong Kong dollar exchange rate was broadly stable. However, strengthening pressure again gathered pace, moving the Hong Kong dollar exchange rate closer towards the strong-side CU of 7.75 for the rest of the year.

Between 19 October and 21 December, the strong-side CU was repeatedly triggered and the HKMA passively purchased a total of US\$13.8 billion in response to banks' offers, creating HK\$107.2 billion consistent with the Currency Board system. As a result, the Aggregate Balance increased to \$255.9 billion on 31 December from \$148.7 billion a year ago (Chart 2). The inflows partly reflected the increased allocation to Hong Kong dollar assets by investors outside Hong Kong, as well as the proceeds from the issuance of foreign currency bonds by Hong Kong firms in exchange for Hong Kong dollars. The stronger equity initial public offerings activities in late November and December to some extent also supported the inflows.

Chart 1 Market exchange rate in 2012



Chart 2 Aggregate Balance in 2012

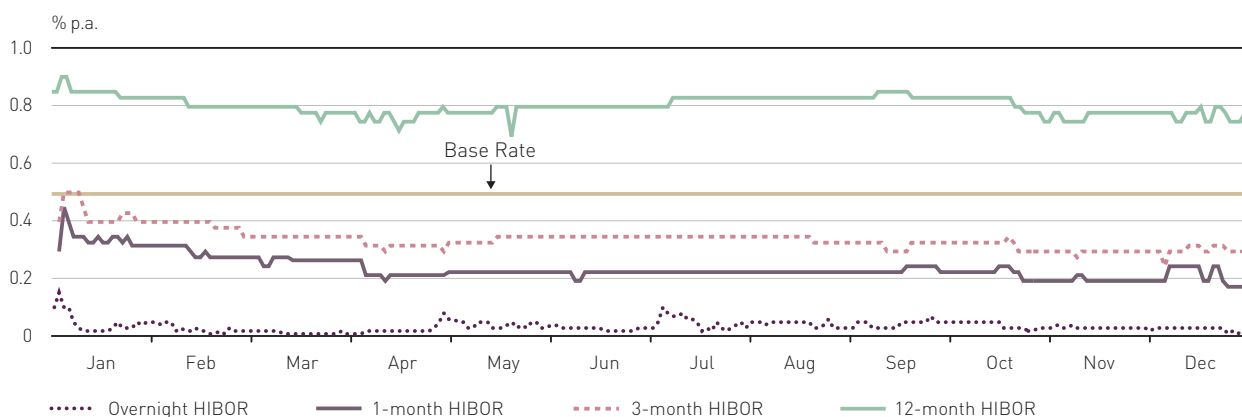


Money market

Interbank liquidity improved steadily during the year. After temporary rises towards the end of 2011, the Hong Kong dollar interbank interest rates eased back in early 2012, tracking the downward movements in the US dollar interbank interest rates and partly due to a respite in the European sovereign debt problems (Chart 3). The interbank interest rates then held broadly stable,

before ticking down again in the fourth quarter with the triggering of the strong-side CU and the corresponding rise in the Aggregate Balance. For the whole of 2012, short-dated interbank rates continued to stay much below the Base Rate of 0.5%. Discount Window borrowing was not active and amounted to only HK\$3.0 billion. Overall, the money market and the forward market continued to operate orderly and smoothly.

Chart 3 Hong Kong dollar interbank interest rates and the Base Rate in 2012



Monetary Stability

The Linked Exchange Rate system

Against the backdrop of additional quantitative easing in the US and the triggering of the strong-side CU, there was renewed discussion among commentators about the soundness of the LERS. The Hong Kong Special Administrative Region Government reiterated its full commitment to the LERS, and the HKMA also explained to the public that when the strong-side CU is triggered by capital inflows, its ability to create Hong Kong dollars is unlimited under the Currency Board system. Stability in the foreign exchange and money markets suggests the public has strong confidence in the Government's commitment. In its annual Article IV Consultation with Hong Kong, the International Monetary Fund (IMF) strongly endorsed the LERS as a simple, credible, transparent and widely understood exchange rate system which has contributed immensely to the maintenance of monetary and financial stability in Hong Kong.

A sound banking system is a crucial condition for the normal functioning of the LERS. During the year, the HKMA continued to closely monitor banks' exposure to the property market and stepped up its supervisory efforts on mortgage lending. In September, after the announcement

of additional quantitative easing in the US, the HKMA introduced a new round of prudential measures to further strengthen banks' risk management in property mortgage lending business, including tightened underwriting criteria for loans to borrowers with multiple property mortgages and a newly introduced ceiling for loan tenors. The HKMA also reminded the public to manage carefully the risk of higher interest rates.

To improve the transparency of the Currency Board Account, a specific portion of Exchange Fund assets has been allocated to back the Monetary Base since October 1998. The Backing Ratio (defined as the Backing Assets divided by the Monetary Base) moved within a tight range of 108 – 109% during 2012, without touching the Upper or Lower Trigger Level. The ratio closed at 108.1% on 31 December (Chart 4). Under the LERS, while specific Exchange Fund assets have been designated for the Backing Portfolio, all Exchange Fund assets are available to support the Hong Kong dollar exchange rate. The large amount of financial resources under the Fund is a powerful buttress protecting Hong Kong's monetary and financial stability in the event of a crisis.

Chart 4 Daily movement of the Backing Ratio in 2012



Other activities

The EFAC Currency Board Sub-Committee monitors and reviews issues relevant to monetary and financial stability in Hong Kong. In 2012, the Sub-Committee considered issues including the impact of Mainland China on Hong Kong's monetary conditions through the credit channels, the usefulness of non-core liabilities as a financial stability surveillance indicator, the safe-havenness¹ of the Hong Kong dollar and various currencies in relation to the US dollar, and the underlying causes for the change in Hong Kong's current account balance. Records of the Sub-Committee's discussions on these issues and the reports on Currency Board operations submitted to the Sub-Committee were published on the HKMA website.

The Hong Kong Institute for Monetary Research (HKIMR) continued to sponsor research in the fields of monetary policy, banking and finance. In 2012, it hosted 20 research fellows, published 32 working papers and one occasional paper.

The Institute also organised seven international conferences and workshops. The main ones included:

- The Third Annual International Conference on the Chinese Economy held in January with the theme "China's Macroeconomic Performance in the Medium-Term: Deepening Reforms and Further Opening Up". The conference covered a wide range of issues, such as China's external imbalances, labour incomes, productivity growth, monetary policies and interest rates, informal financing, and exchange rate policies
- The Fourth Financial Stability Conference of the International Journal of Central Banking held in May on Financial Crises: Causes, Consequences and Policy Options, which dealt with topics including the impact of unconventional monetary policy, the roles of credit supply, demand shocks on business cycles and financial crises, and capital and macroprudential regulation

- The Fifth Expert Forum on Advanced Stress Testing Techniques held in October, which was jointly organised by the Institute and the Monetary and Capital Markets Department of the IMF. The Forum brought together experts and practitioners from various central banks and international organisations who shared their knowledge and experience on best practices for banking system stress testing
- The BRICS² & Asia, Currency Internationalisation, and International Monetary Reform conference held in December, which was co-organised with The Centre for International Governance Innovation and the Asian Development Bank. The conference examined a range of issues on the fundamental systemic problems pushing economies to seek international monetary reforms, and presented views from the BRICS and Asian economies on currency internationalization and international monetary reform.

The Institute organised the tenth annual summer workshop, which discussed financial regulation, the dynamics of renminbi forward exchange rate markets, an optimal monetary policy under financial sector risk, the perils of quantitative easing, and eurodollar banking and currency internationalisation. It also held the tenth HKIMR conference on Mainland China's economy with the theme "Chinese Firms and Capital Going Global: Opportunities and Challenges". The conferences and workshops were attended by participants from academia, the financial services industry and global central banks. In addition, 28 public seminars were organised during the year covering a broad range of economic and monetary issues.

¹ The term "safe-havenness" refers to the degree of a financial asset playing the role of a safe haven, or the extent to which a financial asset is regarded by investors as a safe haven.

² Brazil, Russia, India, China and South Africa.

Monetary Stability

Notes and coins

At the end of 2012, the total value of banknotes in circulation was \$291.7 billion, an increase of 12.3% from a year earlier (Charts 5, 6 and 7). The total value of government-issued notes and coins in circulation amounted to \$9.8 billion, up 0.7% (Charts 8 and 9). The value of \$10 notes issued by the Government in circulation (both paper and polymer notes) reached \$3.5 billion, a decrease of 5.8% from 2011.

Chart 5 Banknotes in circulation by note-issuing banks at the end of 2012

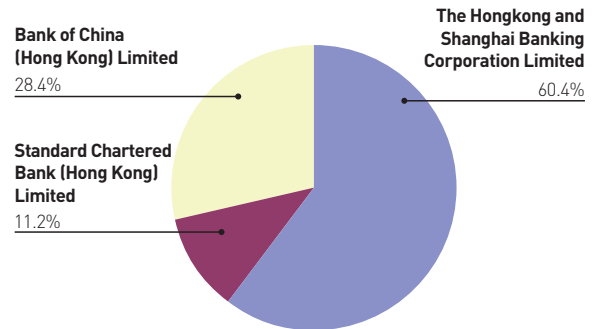
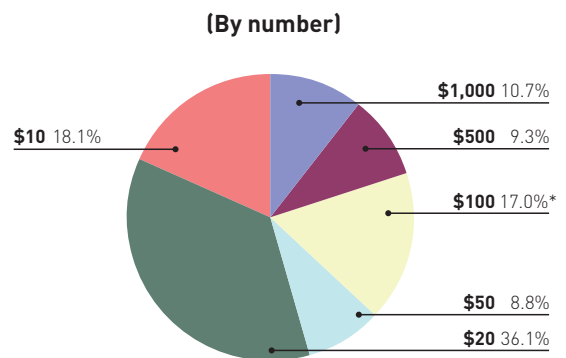
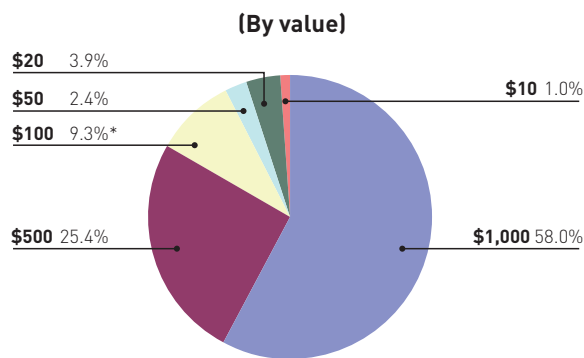


Chart 6 Distribution of banknotes in circulation at the end of 2012



* Includes 0.1 percentage point contributed by \$150 banknotes.

Chart 7 Banknotes in circulation at the end of 2012

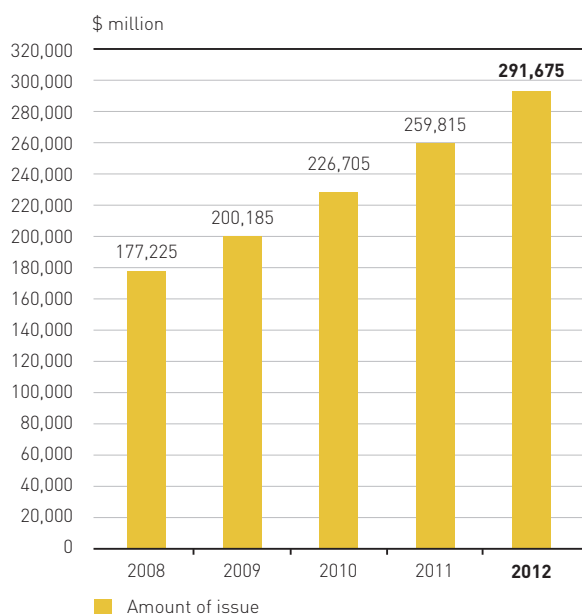


Chart 8 Government-issued notes and coins in circulation at the end of 2012

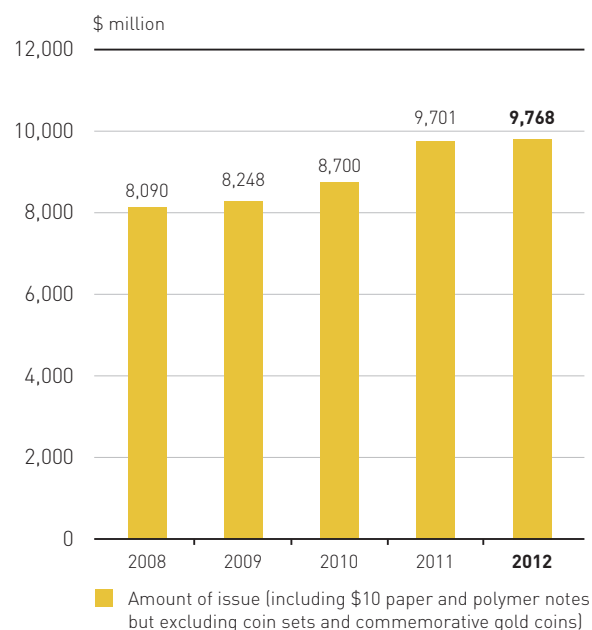
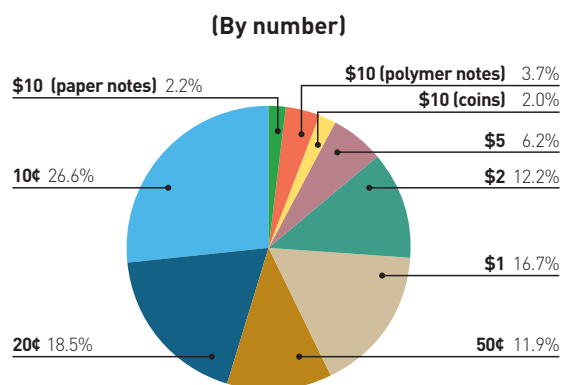
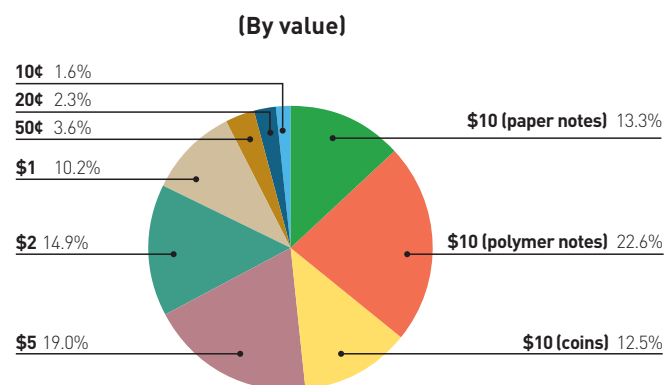


Chart 9 Government-issued notes and coins in circulation at the end of 2012



Monetary Stability

Hong Kong banknotes

All five denominations of the 2010 series banknotes have been in circulation since January 2012 and have been well received by the public. The security features are effective and easy to use, and the accessibility features are useful to the visually impaired in differentiating denominations. Public education programmes on the security features of Hong Kong Banknotes continue to be popular. During the year, 30 seminars were organised for over 5,000 participants, including bank tellers, retailers and students, to provide them with knowledge and skills for authenticating banknotes.

\$10 polymer note

About 221 million polymer notes were in circulation at the end of 2012, representing 63% of the \$10 notes issued by the Government.

Coin replacement programme

The withdrawal of coins bearing the Queen's Head design continued, with nine million coins removed from circulation in 2012.

Exchange Fund Bills and Notes

The HKMA streamlined the performance assessment framework for Market Makers under the Exchange Fund Bills and Notes (EFBN) Programme. The four quarterly reviews of Market Makers' performance each year were consolidated into two half-yearly exercises. The HKMA also adopted a more comprehensive approach in the selection of Eligible Market Makers, covering a broader range of quantitative and qualitative aspects of their performance, such as their activities in the primary and secondary markets of EFBN, and the quality of their market intelligence.

During the year, the HKMA continued to fine-tune the maturity mix of the EFBN with increased issuance of 10-year and 15-year Exchange Fund Notes. By the end of 2012, the amount of outstanding Exchange Fund paper stood at \$657 billion (Table 2).

Table 2 Outstanding issues of Exchange Fund Bills and Notes

\$ million	2012	2011
Exchange Fund Bills (by original maturity)		
28 days	600	600
91 days	350,884	348,313
182 days	195,000	195,000
364 days	42,200	42,200
Sub-total	588,684	586,113
Exchange Fund Notes (by remaining tenor)		
1 year or below	17,000	17,000
Over 1 year and up to 3 years	25,900	28,000
Over 3 years and up to 5 years	11,200	10,900
Over 5 years and up to 10 years	8,600	8,000
Over 10 years	6,000	5,400
Sub-total	68,700	69,300
Total	657,384	655,413

PLANS FOR 2013 AND BEYOND

The macro-financial environment is expected to remain challenging for Hong Kong in 2013. The European sovereign debt problems are not fully resolved and this will weigh on the region's growth prospects. In the US, political wrangling will continue to pose fiscal uncertainties in the near term. For Hong Kong, aggressive monetary easing in advanced economies and the loose monetary conditions could exert upward pressure on consumer and asset prices. In addition, fund flows and financial markets could be exposed to volatility, thereby posing risks to macro-financial stability.

The HKMA will continue to closely monitor the risks and vulnerabilities in the domestic and external environment, and stand ready to deploy appropriate measures to maintain monetary and financial stability in Hong Kong. Research programmes will examine issues affecting the economy and assess their potential risks. The EFAC Currency Board Sub-Committee will continue to examine issues relevant to Hong Kong's monetary and financial stability, review the technical aspects of the Currency Board arrangements and, where appropriate, recommend measures to strengthen them.